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SUBJECT: DOMINICAN ECONOMY VULNERABLE TO GLOBAL CRISIS

REF: SANTO DOMINGO 1608

¶1. (SBU) Summary: The global financial crisis has not yet had a serious impact in the Dominican Republic where the banking system appears to be in relatively good shape as a result of stronger regulatory measures put into place after the 2003 banking crisis. However, the private sector is publicly expressing concern over the potential economic impact in the DR of a prolonged slow down in the U.S. economy, especially in the areas of tourism and foreign direct investment, and has called on the government to prepare a strategy to address the problem. In addition, the private sector has been increasingly critical of the government,s deficit spending and has called on the Fernandez administration to reign in government expenditures, including the electricity subsidy which could total as much as USD 1.2 billion this year. So far, the Dominican government has been unusually quiet, making few statements on the ongoing global economic crisis, despite recent dire warnings from the IMF and UN that developing economies such as the DR could suffer the most. End Summary.

Government Response

¶2. (SBU) The response of the Dominican government to the global financial crisis has been muted despite extensive coverage by the Dominican media. On October 3, President Fernandez spoke at a conference in Miami and acknowledged that the financial crisis could limit the amount of credit available to the country; however, he has not made any other public comments on the ongoing crisis. Fernandez,s main priority at the moment is his proposed constitutional reform package (reftel) which is being considered by the Congress. The rest of his economic team has also been relatively quiet, thus giving the impression that they are unengaged. The government initially planned to send only a low-level delegation to the annual IMF and World Bank meetings in Washington with Finance Minister Vicente Bengoa only deciding to attend at the very last minute.

¶3. (U) On October 7, the Minister of Economy, Development and Planning Temistocles Montas held a videoconference for government officials with the United Nations Conference on Trade and Development (UNCTAD) to discuss the global crisis and the potential effects on the DR. UNCTAD was very clear in its warning that the economic impact for the DR could be severe given the DR,s dependence on the U.S. economy and this message was widely covered in the press. The IMF also warned that the Dominican economy is at risk and placed the DR in a category of countries most vulnerable in face of the global economic crisis. In response, Finance Minister Bengoa told the media the IMF needs to intervene in the U.S. economy which &has more problems than the Dominican economy.8

¶4. (U) As a result of the external oil and food price shocks this year and increased spending in the lead up to the May 2008 Presidential election, the Dominican government,s

fiscal deficit has grown. The private sector has repeatedly called on the government to cut spending, especially subsidies. The subsidy for the electricity sector is expected to be as much as USD 1.2 billion this year. The government response so far has been to maintain a restrictive monetary policy to keep interest rates high, to try to curb inflation and maintain a stable exchange rate. The Finance Minister announced on October 15 that government tax revenues were projected to fall this year, in part due to reduced consumer spending and the temporary closing of the Falconbridge mine as a result of low nickel prices in the world market. He described September as one of the worst months ever for the government fiscal situation.

Financial system is sound

¶5. (SBU) Manuel Grullon, President of Banco Popular, the largest bank in the country, told Econoff that he believes the Dominican banking system is pretty strong. He added that as a consequence of the 2003 financial crisis, banks were required to increase capital and reserves and these measures are still in place. Grullon emphasized that the prudential regulations put into place after the 2003 crisis strengthened the banks balance sheets and also put into place stricter requirements for commercial loans. His one concern was a measure which put a 10 percent limit on capital investments by Dominican banks in other financial institutions, including government treasuries. Grullon said the bank was considering asking the banking regulators to modify this requirement in light of the current global crisis since in his view U.S. Treasury bills are the safest place to put money at the moment.

¶6. (SBU) Grullon noted that as a result of stricter commercial loan requirements, banks shifted their focus to consumer and mortgage loans which are now facing pressure from higher interest rates. He added that it is important to make a distinction between commercial banks, which faced increased regulation after the crisis, and savings and loans which were only addressed more recently. Grullon said the savings and loans have a much larger share of mortgage credit in the domestic market (30-60 percent of their portfolios) than the commercial banks (10-15 percent of their portfolios) and therefore the savings and loans are more sensitive to interest rates increases. He commented that Banco Popular is trying not to raise mortgage rates too much compared to other loans since the bank would lose more if the number of mortgage defaults increased. Grullon pointed to auto loans where rates have increased 10 points in four months (from 15 to 25 percent) and business has dropped significantly. Grullon was critical of the Central Banks,s restrictive monetary policy which has led to &a home grown credit crunch8 in the local market. He said his most important concern is that there is no erosion of confidence in the Dominican financial system.

Citibank concerned about economic impact

¶7. (SBU) Max Vidal, General Manager of Citibank, told Econoff that he believes the economic impact of the global crisis will start to be felt in the DR at the beginning of 2009. He noted that a tightened global credit market will make it difficult for investors to fund large projects and they may face delays or much higher costs. Vidal said he has already seen a couple of projects delayed and expects the number to increase, especially in the areas of infrastructure projects and tourism development. Vidal also commented that he believes the local financial system is fairly strong. However, he noted that Wachovia is a key foreign correspondent bank in the DR and an important source of short-term capital for trade. Therefore, he said the future of Wachovia is important to the DR economy. (Note: This conversation took place before Citibank withdrew its offer to purchase Wachovia. In a separate conversation also before Citibank,s withdrawal, Jose Obregon, Vice President of the Wachovia Representation Office in the DR, told econoff that if Wells Fargo purchases the bank he is hopeful that Wachovia will remain in the market with little change. End Note.)

¶8. (SBU) Vidal commented that there is a public perception that the government is not reacting to the global crisis and therefore not taking it seriously. He warned that the government needs to address its fiscal deficit before the economic impact of the U.S. slowdown is felt. Vidal noted the ongoing payment crisis in the electricity sector (septel) and emphasized the need for the government to find the political will to address the problem which affects all areas of the economy. He added that it will be more difficult for the government to find financing for this growing subsidy which is a huge drain on government resources. Vidal said he expects interest rates to stay high but not to increase much more as a result of the government,s efforts to curb inflation and maintain exchange rate stability.

Comment

¶9. (SBU) More than halfway through his first 100 days in office President Fernandez has shown no intention of taking advantage of his new term to address pressing fiscal problems such as the large subsidies weighing down the government budget. Instead he appears to be focusing on seeking new investment from countries such as Qatar and getting his constitutional reform package passed by Congress. This lack of leadership is of great concern to a private sector that is already feeling some effects of the global crisis and are greatly concerned about the potential impact in the DR. Most people believe it is only a question of time before the global crisis hits the local market and they fear the government will not have done anything to prepare the country for the outcome. The question is whether Fernandez will take decisive action or continue to act out of the fear he has expressed to us in the past of "political instability" resulting from economic reforms. End Comment.

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